Attachment A

Pension Liability Management Policy

CITY OF VICTORVILLE
COUNCIL POLICY

SUBJECT: PENSION LIABILITY MANAGEMENT POLICY	**POLICY NO.: CP-24-02**
	DATE: **July 16, 2024**

BACKGROUND

The City recognizes that its unfunded pension liability can cause financial stress on the organization and direct resources away from programs and services necessary for the City's operations and service to the public. This Pension Liability Management Policy ("Policy") is intended to support the decision-making process of the City Council as it applies to the City's unfunded pension liability and should be consistent with the City's financial goals and policy objectives. Adherence to this Policy signals to the public, City employees, rating agencies, and capital markets that the City is well-managed and is able to meet its pension obligations in a timely manner.

This Policy is intended to work in conjunction with the City's other adopted financial policies, including the Reserve Policy, Debt Management Policy, and Budget. This Policy does not cover other post-employment benefits, known as OPEB, which principally involves retiree health care benefits and associated liabilities. Nothing in this Policy shall constitute an obligation upon the City, nor an implied contract. The City Council may revoke or amend this Policy by resolution at any time.

PURPOSE

The City's main objective shall be to reduce its unfunded pension liabilities in the most cost-efficient, fiscally prudent, and sustainable manner possible. As with any fiscally prudent policy, the City recognizes that this Policy should:

- Maintain the City's sound financial position;
- Ensure the City has the flexibility to respond to changes in future service priorities, revenue levels, and operating expenditures;
- Provide guidance in making annual budget decisions;
- Protect the City's creditworthiness;
- Ensure that all pension funding decisions are structured to protect both current and future taxpayers, ratepayers, employees, and residents of the City; and
- Ensure that the structure of Pension Obligation Bonds, if authorized and issued, is consistent with the City's strategic planning goals, objectives, capital improvement program, budget, and Debt Management Policy.

POLICY

I. RETIREMENT PLANS AND RETIREMENT BENEFITS

CalPERS is an agent multiple-employer public employee defined benefit pension plan that provides retirement and disability benefits, annual cost of living adjustments, and death benefits to plan members and beneficiaries. CalPERS acts as a common investment and administrative agent for participating public entities within the State, including the City. CalPERS plan benefit provisions and all other requirements are established by State statute and the City Council. The City contributes to CalPERS on behalf of active City employees who participate in the City's Miscellaneous Plan or the City's Safety Plan. Benefits are based on years of credited service, equal to one year of full-time employment. City employees are subject to different benefit levels based on their hire date.

Miscellaneous Plan – The Miscellaneous Plan has a two-tier benefit plan structure. Employees hired before January 1, 2013 receive a benefit formula equal to 2.5% @ 55. Employees hired after January 1, 2013 receive a benefit formula equal to 2.0% @ 62.

Safety Plan – The Safety Plan also has a two-tier benefit plan structure. Employees hired before January 1, 2013 receive a benefit formula equal to 2.5% @ 55. Employees hired after January 1, 2013 receive a benefit formula equal to 2.0% @ 62.

Pension costs associated with each Plan are allocated across the City's various funds and entities based on payroll.

II. PENSION CONTRIBUTIONS AND AMORTIZATION BASES

The City is statutorily required to make pension contributions on an annual basis to each plan. The City shall make a commitment to fund the full amount of the annual contribution each year. The annual pension contribution is comprised of two component parts: 1) normal costs; and 2) unfunded actuarial liability.

> *Normal Costs* - represent the current year's pension obligation or the cost of retirement benefits earned by current employees during the year. Normal Costs are calculated based on a percentage of payroll.
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> *Unfunded Actuarial Liability (UAL)* – is the difference between the total pension liability less the current market value of assets in the pension fund, which represents the funding shortfall for benefits previously earned by current employees and City retirees. This amount effectively represents a "past due" amount.

CalPERS recalculates the UAL balance and payment schedule every year, and a number of factors impact the accrued liability. Additionally, the market value of assets can change dramatically from year to year depending on investment performance. To address these differences, at the end of each year, CalPERS adds new amortization bases to adjust the UAL for changes to the system. Amortization bases are the component parts of the UAL. They function like "individual loans" that have distinct payment schedules and terms. The payment schedule for each amortization base is calculated using the current Discount Rate (currently 6.80%). Each base is amortized over specific periods, in accordance with

CalPERS amortization policies. *The UAL is a dynamic liability, and the City should anticipate that its UAL payment schedule will fluctuate as a result of everchanging variables, making the management of pension liabilities an ongoing evaluation and management process.*

GENERAL PROVISIONS

The financial objective of a defined benefit pension plan is to fund the long-term cost of benefits provided to the plan members. In order to assure that the plan is financially sustainable, the plan should accumulate adequate resources in a systematic and disciplined manner over the active service life of benefitting employees.

I. MANAGING PENSION LIABILITIES

A. Additional Discretionary Payments (ADPs) to CalPERS

The City can make Additional Discretionary Payments (ADPs)—payments above and beyond the annually required contributions (ARC) calculated by CalPERS. These payments can be used to prepay small amounts of “principal” on the UAL, thereby saving the associated “interest” (calculated at the Discount Rate) that is charged to the City. “Slow and steady” ADPs chip away at the City’s pension obligations; and over time, this strategy improves the Plans’ funding status and can result in significant savings. Additionally, making smaller ADPs to CalPERS on a regular basis (i.e., dollar cost averaging) mitigates the market timing risk of a large lump sum deposit with CalPERS that is invested in the market all at once.

B. Section 115 Trust

The timing of when funds are available may not line up with the timing and amounts of ADPs that the City desires to make to CalPERS. This should not prevent the City from accumulating funds it desires to allocate towards paying down its pension obligations. A Section 115 Trust allows the City to build its pension reserve while maintaining oversight of investment management and control over the risk tolerance and investment return targets of the portfolio. Money placed into the trust is irrevocable, meaning it cannot be withdrawn and used for another type of expenditure of the City. The benefits of a Section 115 Trust include:

1. Assets in the trust will offset liabilities on the City’s balance sheet.

2. Assets held in trust will allow for greater investment flexibility and risk diversification compared to the City’s investment portfolio.

3. The City will control the risk tolerance (i.e., conservative, moderate, or aggressive) of the portfolio. The City should hire an investment advisor to manage the Section 115 Trust.

4. The City will have the flexibility to access trust assets any time, as long

as they are used to pay employer pension obligations (including normal costs).

5. Assets can be used to make “slow and steady” ADPs to achieve UAL savings over time.

C. Pension Stabilization Reserve Fund

Because the City’s current UAL payment schedule is projected to increase through Fiscal Year 2030 by $2.6 million, it is important for the City to maintain a reserve to supplement pension costs, including normal costs, offset future unexpected contribution rate increases, and use as a rainy-day fund when revenues are impaired based on economic or other conditions.

It shall be the City’s policy to consider applying available resources to its Pension Stabilization Reserve Fund with a target balance of $2.6 million. Each year, staff will assess whether the target balance of $2.6 million remains suitable. Staff shall seek Council approval for making withdrawals from the Pension Stabilization Reserve Fund or for changing the target balance.

It is recognized that monies in this reserve fund are subject to California Government Code investment restrictions and the City’s Investment Policy and therefore has a lower investment return risk than a Section 115 Trust.

D. Accelerate Payment of New Amortization Bases

The City may seek to accelerate the repayment of any new Amortization Bases added to the UAL, thereby reducing overall “interest” costs.

II. FUNDING SOURCES FOR MANAGING PENSION LIABILITIES

A. Reserves, One-Time Monies, and Savings

To the extent that the City has excess reserves, unspent budget monies at year-end, unspent proceeds from capital projects, and/or one-time revenues or any additional resources, the City shall consider applying a portion of such monies toward its unfunded pension liabilities. The allocation of additional resources shall be made on a case-by-case basis by the City Council, with input from the City Manager after all discretionary fund reserve balances, cash flows, and one-time monies have been reviewed by City staff. There shall be an annual assessment of allocation of reserves and/or one-time monies consistent with the City’s Reserve Policy.

1. Reserves

The City seeks to maintain adequate levels of reserves in accordance to its stated reserve goals and adopted Reserve Policy. To the extent that the

City has reserves in its General Fund or other funds in excess of reserve targets, the City may consider allocating the excess toward unfunded pension liabilities.

2. **General Fund Surplus**

Due to a variety of factors, the City may end a fiscal year with a surplus of revenues over expenditures, encumbrances, and commitments. On an annual basis, the City Manager will recommend allocations to the City Council on the use of budget surplus funds. After deficits, reserve deficiencies and other matters of fiscal concern, the City Manager or his/her designee may recommend that 50 percent (50%) of remaining budget surplus funds, up to $1 million, be used to address long-term pension liabilities. The 50% target level is a stated Policy goal; however, individual funding decisions, shall be made on a case-by-case basis.

3. **Debt Service Refunding Savings**

When issuing refunding bonds for savings, the City shall consider setting aside all or a portion of debt service savings to address long-term pension liabilities.

4. **Annual Prepayment Option**

Each year, CalPERS gives its member agencies two options for making its UAL payment: 1) make monthly payments to CalPERS; or 2) make a lower (approximately 3% savings) lump sum payment for the entire year by July 31st to CalPERS. The City has been implementing the second option to take advantage of the savings offered by CalPERS. The City shall continue to make the prepayment every July to CalPERS and set aside the savings to address long-term pension liabilities.

B. Financing Strategies

Because the financing strategies below involve borrowing funds and repaying them at an interest rate, savings achieved with these strategies should be used to make ADPs to CalPERS to further leverage the savings.

1. **Tax-Exempt Exchange**

To the extent the City has pay-go tax-exempt capital projects, the City may consider financing such projects with tax-exempt bonds and using the budgeted pay-go funds to make ADPs towards the UAL. In this case, the City would then use the budgeted UAL payments to pay debt service on the tax-exempt bonds and realize savings from the differential between the tax-exempt bond borrowing rate and the Discount Rate.

2. **Pension Obligation Bonds (POBs)**

Pension obligation bonds (POBs) are taxable bonds that state and local governments have issued as part of an overall strategy to fund the unfunded portion of their pension liabilities. The economic benefit of POBs is premised on the assumption that the bond proceeds, when invested with pension assets in higher-yielding asset classes, will be able to achieve a rate of return that is greater than the interest rate owed over the term of the bonds.

The City may opt to pursue the use of taxable bonds to “refinance” a portion of its unfunded pension liability. There is risk of failing to achieve the targeted rate of return that can burden the City with both the debt service requirements of the taxable bonds and the unfunded pension liabilities that remain unmet. To mitigate this risk, the City shall undertake the following measures prior to and during the issuance of pension obligation bonds as part of a comprehensive strategy to address the City’s unfunded liabilities.

a. Financial Analysis Required Prior to the Issuance of POBs

The following analysis should be completed prior to the issuance of POBs:

i. Estimate Savings Achieved with the Issuance of POBs by Comparing Pension Payments with and without the POB Issuance

The City shall compare the then current UAL payment schedule against a new estimated remaining UAL payment schedule (adjusted for a credit derived from POB proceeds) + POB debt service. This analysis will indicate if the aggregate pension cost savings, assuming then current market conditions, meet a minimum budgetary savings threshold.

ii. Assessment of Risk

The strategy of issuing POBs to pay off all or a portion of outstanding UAL carries market timing risk (i.e., if investment returns are lower than interest costs of the POBs). The City shall identify the level of risk that can be tolerated with this strategy.

b. General Guidelines for the Issuance of POBs

The City shall adhere to the following general guidelines for issuance of POBs:

i. Retirement Plan funding ratios should not exceed 100% after the application of bond proceeds.

ii. The bonds shall only be structured with fixed rate current interest bonds.

iii. The bonds shall not be structured to extend the final maturity date of the UAL or defer payments.

iv. Bonds shall be structured with the most flexible prepayment option that can be achieved in the market without interest rate penalty at the time of issuance.

v. Bonds shall not finance non-current normal costs; they shall only be used to refinance unfunded pension liabilities (and current normal costs).

vi. After the issuance of POBs, the City shall determine an annual dollar amount, based on the expected savings achieved, for making ADPs to CalPERS.

FUNDING GOAL & FUNDING TARGET

While the ultimate goal is to have pension liabilities fully or mostly funded, the City's intermediate goal is to have its pension liabilities to be 80% funded. The funded status goal may be achieved over a several year time frame. The funding level is expected to fluctuate; however, it should not fall below 70%, unless it is due to factors out of the City's control (i.e., unanticipated investment earnings far below CalPERS' investment target in a given year). Calculations for funding level should take into consideration any outstanding pension-related debt, such as pension obligation bonds.

SUPERFUNDING

In the event that either City plans achieve "superfunded" status, where asset values exceed the accrued liability (i.e., funding level exceeds 100%), excess amounts shall not be used for contribution holidays or to enhance benefits. Excess funding amounts should be viewed as reserves to be maintained to protect from future downturns and negative events.

POLICY REVIEW AND AMENDMENT

Addressing retirement costs is a dynamic process. Adjustments are made annually to a City's normal costs and UAL. Therefore, this Policy is intended to serve as a living document that should be reviewed annually. After the release of the most current annual actuarial reports, staff shall present to City Council a summary of each plan's funding status during its annual Mid-Year Budget Review process and will review this Policy to determine if changes are needed to ensure adequate resources are being accumulated. This Policy will incorporate matters by which the responsibility of decision is vested in the City Council. Any amendments to this Policy shall be prepared by the City Manager in writing and approved by action of the City Council.